Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception for reorganization exchanges.

Section 368(a)(1)(D) reorganization. Guidance is provided as to whether a transaction otherwise qualifying under section 368(a)(1)(D) of the Code will be prevented from so qualifying when the acquiring corporation transfers the target corporation's assets to a subsidiary controlled by the acquiring corporation. Rev. Rul. 74–545 obsoleted.

Rev. Rul. 2002–85

ISSUE

Whether an acquiring corporation's transfer of a target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will prevent a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) of the Internal Revenue Code from so qualifying.

FACTS

A, an individual, owns 100 percent of T, a state X corporation. A also owns 100 percent of P, a state Y corporation. For valid business reasons and pursuant to a plan of reorganization, (i) T transfers all of its assets to P in exchange for consideration consisting of 70 percent P voting stock and 30 percent cash, (ii) T then liquidates, distributing the P voting stock and cash to A, and (iii) P subsequently transfers all of the T assets to S, a preexisting, wholly owned state X subsidiary of P, in exchange for stock of S. S will continue T's historic business after the transfer and P will retain the S stock. Without regard to P's transfer of all the T assets to S, the transaction qualifies as a reorganization under § 368(a)(1)(D).

LAW

Section 368(a)(1)(D) provides that the term reorganization means a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, 355, or 356.

Section 354(a) provides that, in general, no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354(b)(1) provides that § 354(a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of § 368(a)(1) unless (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 368(a)(2)(A) provides that if a transaction is described in both §§ 368 (a)(1)(C) and 368(a)(1)(D), then, for purposes of subchapter C (other than for purposes of § 368(a)(2)(C)), such transaction shall be treated as described only in § 368(a)(1)(D).

Section 368(a)(2)(C) provides that a transaction otherwise qualifying under § 368(a)(1)(A), (B), (C), or (G) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled (as defined in § 368(c)) by the corporation acquiring such assets or stock.

Section 368(b) provides that the term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations in the case of a reorganization resulting from the acquisition by one corporation of the properties of another.

Congress enacted § 368(a)(2)(C) in response to the Supreme Court decisions in *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938). In *Groman*, the shareholders of one corporation (Target) entered into an agreement with another corporation (Parent) pursuant to which Target would merge into Parent's newly formed subsidiary (Sub). In the transaction, the Target shareholders transferred their Target shares to Sub in exchange for shares of Parent, shares of Sub, and cash, and Target liquidated. The Court concluded that, even though the statutory definition of "party to a reorganization" was not exclusive, Parent was not a party to the reorganization because it received nothing in the exchange. The Court then stated that an exchange that is pursuant to a plan of reorganization is not taxable to the extent the interest of the stockholders of a corporation continue to be definitely represented in substantial measure in a new or different corporation. The stock of Parent, however, did not represent a continued substantial interest in the assets conveyed to Sub. Because Parent was not a party to the reorganization, the Court held that the receipt of the stock of Parent was taxable.

In *Bashford*, a corporation (Parent) wished to acquire three competitors (Targets). Pursuant to a plan, Parent formed a new corporation (Sub) and acquired all the preferred shares and a majority of the common shares of Sub. Sub became the owner of the stock and assets of the Targets. The former stockholders of the Targets exchanged their shares in the Targets for shares of Sub, shares of Parent, and cash. Because any direct ownership by Parent of the Targets was transitory and without real substance, the Court saw no significant distinction between this transaction and the transaction in *Groman*. Therefore, the Court concluded that Parent was not a party to the reorganization. Hence, the Parent stock received by the shareholders of the Targets did not confer the requisite continuity of interest.

In 1954, Congress enacted § 368(a)(2)(C) in response to *Groman* and *Bashford*. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 52, 273, 275 (1954). As originally enacted, § 368(a)(2)(C) applied only to reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), but Congress has since amended the statute to apply to other reorganizations. Specifically, Congress amended § 368(a)(2)(C) in 1964 to apply to reorganizations under § 368(a)(1)(B), and, in 1980, to reorganizations under § 368(a)(1)(G).

Section 1.368–2(k)(1) of the Income Tax Regulations restates the general rule of § 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations to be successively transferred to one or more corporations controlled (as defined in § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization.

Section 1.368–2(f) provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368–2(k).

To qualify as a reorganization under § 368, a transaction must satisfy the continuity of business enterprise (COBE) requirement. The COBE requirement is intended to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. Section 1.368–1(d)(1). Section 1.368–1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business. Pursuant to § 1.368–1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its qualified group. Section 1.368–1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

In Rev. Rul. 88–48, 1988–1 C.B. 117, in a taxable transaction, corporation X sold 50 percent of its historic business assets to unrelated purchasers for cash. Immediately afterwards, pursuant to an overall plan, X transferred to corporation Y, a corporation unrelated to X and the purchasers, all of its assets, including the cash from the sale. The ruling holds that X's transfer of assets to Y satisfied the substantially all requirement of § 368(a)(1)(C).

In Rev. Rul. 2001–25, 2001–1 C.B. 1291, pursuant to a plan, corporation S, a wholly owned subsidiary of corporation P, merged with and into corporation T in a state law merger. Immediately after the merger and as part of a plan that included the merger, T sold 50 percent of its operating assets for cash to an unrelated corporation. After the sale of the assets to corporation X, T retained the sales proceeds. Without regard to the requirement that T hold substantially all of the assets of T and S immediately after the merger, the merger satisfied all the other requirements applicable to reorganizations under §§ 368(a)(1)(A) and 368(a)(2)(E). The Service ruled that even though T's post-merger sale of 50 percent of its operating assets prevented T from holding substantially all of its historic business assets immediately after the merger, because the sales proceeds continued to be held by T, the merger did not violate the requirement of § 368(a)(2)(E) that the surviving corporation hold substantially all of its properties after the transaction.

In Rev. Rul. 2001–24, 2001–1 C.B. 1290, corporation X merged with and into corporation S, a newly organized, wholly owned subsidiary of corporation P, in a transaction intended to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). S continued the historic business of X following the merger. Following the merger and as part of the plan of reorganization, P transferred the S stock to corporation S1, a preexisting, wholly owned subsidiary of P. The Service ruled that the transaction satisfied the continuity of business enterprise requirement of § 1.368–1(d). Analyzing whether P's transfer of the S stock to S1 caused P to fail to control S for purposes of § 368(a)(2)(D) and caused P to fail to be a party to the reorganization, the Service noted that the legislative history of § 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly. Section 1.368–2(k)(2) permits the transfer of stock or assets to a controlled corporation following a reverse triangular merger under §§ 368(a)(1)(A) and

368(a)(2)(E), which supports permitting P to transfer the S stock to S1 without causing the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). Furthermore, although §§ 368(a)(2)(C) and 1.368–2(k) do not specifically address P's transfer of S stock to S1 following a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D), § 368 (a)(2)(C) is permissive rather than exclusive or restrictive. Accordingly, the Service concluded that the transfer of the S stock to S1 would not cause P to be treated as not in control of S for purposes of § 368(a)(2)(D) and would not cause P to fail to be treated as a party to the reorganization.

ANALYSIS

Neither § 368(a)(2)(C) nor § 368(a)(2)(A) indicates that an acquiring corporation's transfer of assets to a controlled subsidiary necessarily prevents a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) from so qualifying. Because § 368(a)(2)(C) is permissive and not exclusive or restrictive, the absence of § 368(a)(1)(D) from § 368(a)(2)(C) does not indicate that such a transfer following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will prevent the transaction from qualifying as such. Furthermore, although § 368(a)(2)(A) contains the parenthetical exception "other than for purposes of [§ 368(a)(2)(C)]," that exception appears to have been provided in the same spirit as § 368(a)(2)(C), *i.e.*, to resolve doubts about the qualification of transactions as reorganizations, and does not indicate that the transfer of assets to a controlled subsidiary necessarily prevents a transaction from qualifying as a reorganization under § 368(a)(1)(D). *See* S. Rep. No. 313, 99th Cong., 2d Sess. 914 (1986).

Accordingly, an acquiring corporation's transfer of assets to a controlled subsidiary following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will not cause a transaction to fail to qualify as such, provided that the original transferee is treated as acquiring substantially all of the assets of the target corporation, the transaction satisfies the COBE requirement and does not fail under the remote continuity principle of *Groman* and *Bashford*, and the transfer of assets to a controlled corporation does not prevent the original transferee from being a "party to the reorganization."

Section 354(b)(1)(A) requires that, in a reorganization under § 368(a)(1)(D), the corporation to which the assets are transferred acquire substantially all of the assets of the transferor of such assets. In this case, the requirement that P acquire substantially all of T's assets is satisfied because P retains the stock of S. *See* Rev. Rul. 2001–24; Rev. Rul. 88–48.

To qualify as a reorganization under § 368(a)(1)(D), a transaction must satisfy the COBE requirement of § 1.368–1(d). In the present transaction, P and S constitute a qualified group, and S will continue T's historic business after the transfer. Therefore, the transaction satisfies the COBE requirement.

As described above, Congress enacted § 368(a)(2)(C) in response to the Supreme Court's holdings in *Groman* and *Bashford*. After the enactment of § 368(a)(2)(C), however, the Service continued to apply the principles of *Groman* and *Bashford* to transactions that otherwise qualified as reorganizations under § 368(a)(1)(B). *See* Rev. Rul. 63–234, 1963–2 C.B. 148. In response to this position, Congress expanded the scope of § 368(a)(2)(C) to include reorganizations under § 368(a)(1)(B). Congress' response to the application of the principles of *Groman* and *Bashford* has been to limit the application of those principles. Implicit in Congress' enactment and expansion of § 368(a)(2)(C) is a rejection of the principle that the transfer of acquired stock or assets to a controlled subsidiary of the acquiring corporation creates a remote continuity problem that causes a transaction that otherwise qualifies as a reorganization to fail to so qualify. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A134 (1954) (stating, after citing *Groman* and *Bashford* in reference to proposed legislation that ultimately became § 368(a)(2)(C), "a corporation may not acquire assets with the intention of transferring them to a stranger").

Under the COBE regulations, stock or assets acquired in transactions that satisfy certain provisions of § 368(a)(1) may be transferred without limitation to successive lower-tier controlled subsidiaries within a qualified group. The Preamble to the final COBE regulations states that "the IRS and Treasury believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny. Thus, [the final COBE regulations] do not separately articulate rules addressing remote continuity of interest." T.D. 8760, 1998–1 C.B. 803, Supplementary Information (Explanation of Provisions). Accordingly, a transfer of acquired stock or assets will not cause a transaction to fail for remote continuity if it satisfies the COBE requirement.

Under the facts described above, P's transfer of the T assets to S pursuant to the plan of reorganization satisfies the COBE requirement. Therefore, the transaction does not fail for remote continuity.

Section 368(b) provides that the term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations in the case of a reorganization resulting from the acquisition by one corporation of the properties of another. The use of the word "includes" in § 368(b) indicates that the definition of "party to a reorganization" is not exclusive. *See* § 7701(c); *Groman*, *supra*, at 86 (stating that "when an exclusive definition is intended the word 'means' is employed . . . whereas [in the definition of "party to a reorganization"] the word used is 'includes'"). Furthermore, § 1.368–2(f), which interprets § 368(b), provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to a reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368–2(k). Section 1.368–2(k) does not reference § 368(a)(1)(D). Nonetheless, because § 1.368–2(k) restates and interprets § 368(a)(2)(C), which is a permissive and not an exclusive or restrictive provision, § 1.368–2(k) also should be viewed as permissive and not exclusive or restrictive. Therefore, because §§ 368(b), 1.368–2(f), and 1.368–2(k) are not exclusive or restrictive provisions, the absence of § 368(a)(1)(D) from § 1.368–2(k) does not prevent a corporation from remaining a party to a reorganization even if the acquired stock or assets are transferred to a controlled subsidiary.

Reorganizations under § 368(a)(1)(D), like reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), are asset reorganizations. In reorganizations under §§ 368 (a)(1)(A) and 368(a)(1)(C), the original transferee is treated as a party to a reorganization, even if the acquired assets are transferred to a controlled subsidiary of the original transferee. The differences between reorganizations under § 368(a)(1)(D) on the one hand and reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C) on the other hand do not warrant treating the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under § 368(a)(1)(D) differently from the original transferee in a reorganization under § 368(a)(1)(A) or 368(a)(1)(C) for purposes of § 368(b). Therefore, the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under § 368(a)(1)(D) is treated as a party to the reorganization, notwithstanding the original transferee's transfer of acquired assets to a controlled subsidiary of the original transferee.

For the reasons set forth above, P's transfer of the T assets to S will not prevent P's acquisition of those assets from T in exchange for P voting stock and cash from qualifying as a reorganization under § 368(a)(1)(D).

HOLDING

An acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will not prevent a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) from so qualifying.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 74–545, 1974–2 C.B. 122, is obsoleted. In Rev. Rul. 74–545, the Service ruled that, for purposes of § 368(a)(2)(A), a transaction that qualified as a reorganization under § 368(a)(1)(C) was "described in" § 368(a)(1)(D) even though it did not qualify as a reorganization under § 368(a)(1)(D). In that ruling, the target corporation did not satisfy the requirement of § 354(b)(1)(B) because it did not distribute all of its remaining assets along with the stock of the acquiring corporation. The Service reasoned that the purpose of § 368(a)(2)(A) was to ensure that divisive transactions would not be able to avoid the requirements of § 355 by qualifying as a reorganization under § 368(a)(1)(C). Congress, however, resolved this problem in 1984 when it added § 368(a)(2)(G), which requires the target corporation in a reorganization under § 368(a)(1)(C) to distribute the stock, securities, and other properties that it receives, as well as its other properties, in pursuance of the plan of reorganization. This distribution requirement prevents divisive reorganizations that are "described in" § 368(a)(1)(D) from qualifying as reorganizations under § 368(a)(1)(C). Therefore, Rev. Rul. 74–545 is obsolete.

APPLICATION

Pursuant to § 7805(b)(8), the Service will not apply the principles of this revenue ruling to challenge a taxpayer's position that a transaction that occurs on or before December 9, 2002, or a transaction that is effected pursuant to a written agreement (subject to customary conditions) that is binding on December 9, 2002, and at all times thereafter until the date of the transaction does not qualify as a reorganization under § 368(a)(1)(D), provided that, if the taxpayer is the acquiring corporation (or a shareholder of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation, such as a shareholder of an acquiring S corporation), the target corporation (and the shareholders of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation) also treats the transaction as not qualifying as a reorganization under § 368(a)(1)(D) for Federal income tax purposes, and if the taxpayer is the target corporation (or a shareholder of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation), the acquiring corporation (and the shareholders of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation) also treats the transaction as not qualifying as a reorganization under § 368(a)(1)(D) for Federal income tax purposes.

In addition, if a U.S. person that is a shareholder of a target corporation has taken a position consistent with the principles of this revenue ruling for a transfer occurring on or after July 20, 1998, and on or before December 9, 2002, which transfer involved the U.S. person's exchange of stock or securities of the target corporation for stock or securities of a foreign acquiring corporation in which the foreign acquiring corporation transferred part or all of the acquired corporation's assets to a subsidiary controlled by the acquiring corporation as part of the plan of reorganization, then such transfer constituted an indirect transfer of stock or securities by the U.S. person to the foreign acquiring corporation. *See* §§ 1.367(a)–1T(c) and 1.367(a)–3(d). To the extent such U.S. person has not entered into a gain recognition agreement (GRA) satisfying the requirements of § 1.367(a)–3(b)(1)(ii) or 1.367(a)–3(c)(1)(iii)(B) in connection with a transfer for which the U.S. person has taken a position consistent with the principles of this revenue ruling, the U.S. person will be treated as having timely satisfied the requirements for such a GRA if such U.S. person attaches a GRA that otherwise complies with the requirements of § 1.367(a)–8 to its timely filed (including extensions) original tax return for the taxable year that includes December 9, 2002.

Further, the Service and the Treasury are considering amending the regulations under § 368 to reflect the principles of this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Karen Lau of the Office of Chief Counsel. For further information regarding this revenue ruling, contact Ms. Lau at (202) 622–3300 (not a toll-free call).